In the

Supreme Court of the United States

October Term, 1942.

No. 319.

FIDELITY ASSURANCE ASSOCIATION AND CENTRAL TRUST COMPANY, *PETITIONERS.*

vs.

EDGAR B. SIMS, ET AL.

ON PETITION FOR THE WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF ON BEHALF OF L. H. BROOKS, TRUSTEE, FREDERIC LEAKE AND A. L. GOLDBERG, JR., TRUSTEE, AND DEWEY S. GODFREY, RECEIVER FOR FIDELITY ASSURANCE ASSOCIATION IN THE STATE OF MISSOURI, IN OPPOSITION TO MEMORANDUM OF SECURITIES AND EXCHANGE COMMISSION.

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May It Please the Court:

NECESSITY FOR THIS REPLY BRIEF.

Securities and Exchange Commission has filed a memorandum for the purpose of supporting the petition of Fidelity Assurance Association and Central Trust Company. We feel that the writer of the memorandum has completely overlooked facts appearing in this record, nay evidence compiled by the Securities and Exchange Commission itself,

in its extensive investigation of Investment Companies, which conclusively refute all of the argument contained in the memorandum. The importance of these facts is such, we think, that the omission to give recognition to them leads inescapably to a partial and inadequate understanding of the case. Therefore, since we have no other way of exposing these fallacies, we feel that there is a duty resting upon us to bring these facts to the attention of the Court at this time by means of this reply brief.

QUESTION I—THE INSURANCE QUESTION.

The Securities and Exchange Commission says that the first question raised concerning the correctness of the reasoning by which the Court of Appeal concluded that Fidelity Assurance Association was an insurance corporation at the time the petition was filed is of such importance in the administration of Federal statutes (the Bankruptcy Act and the Investment Company Act) that this Court should undertake to settle it. The reasoning on this point is grounded upon the assumption that it is important that this Court in this case announce a decision as to the applicability of these Federal statutes to other similar companies which have attracted the savings of a large number of persons throughout the United States for investment.

But, the argument goes further than this,—as indeed it must, if the point is to merit any consideration whatsoever—and recognizes that the question is as to the eligibility of such companies for *reorganization* under Chapter X of the Bankruptcy Act. It may seem strange that the writer of the memorandum failed altogether to make any attempt to show that this particular company, Fidelity Assurance Association, *could* or *should* be reorganized. The failure to

do so cannot be ascribed to mere oversight, inadvertence or lack of familiarity with the facts of the case on the part of the author of the brief; for the solicitor representing the Securities and Exchange Commission whose name is signed to the memorandum, in arguing the case before the Court of Appeals, admitted that in his opinion it was "almost" 100 per cent certain that Fidelity could not be reorganized as a going concern of any kind or character. Therefore, they are now driven to use the term "reorganization" with the meaning of liquidation.

Considerable emphasis is placed in the memorandum on the amount of "assets" of Fidelity (95 per cent of which are held in the State deposits), the number of contract holders, and the fact that they are scattered throughout the forty-eight States of the Union and the District of Columbia. It is hardly necessary, we think, to point out that this case may not be transferred from the field of litigation concerning private rights and interests into the field of public interest, merely on account of the amount of money involved or the interstate character of the company's operations. The public interests are not necessarily involved, because of the question made in this case, as to whether this company should be excluded from the Bankruptcy Act. No question of public importance could arise over the problem of distribution of the assets of this defunct company, unless the *principles* of the decision may vitally and materially affect other similar companies which in the future may be similarly situated.

In order to demonstrate, beyond the shadow of doubt, that a decision in this case settles no principles of law which can ever in the future have application to other similar companies, or to contract holders in those companies

whose rights and interests are similar to the contract holders in this case, it is necessary only to refer to the findings of the Securities and Exchange Commission itself, as set forth in its Report on Investment Trusts and Investment Companies. This Report is one of the exhibits in this case, sent up in original form.

We believe that Securities and Exchange Commission will readily agree that, for the purpose of the precise question under consideration, there is a clear line of demarcation between face-amount certificate companies and all other classes of investment companies. This distinction was carefully drawn in the Investment Company Act. It can serve no purpose to call attention to the fact that there are "other large financial institutions which have attracted the savings of large numbers of persons throughout the United States for investment." Our consideration must be limited to face-amount certificate companies as defined by the Investment Company Act.

Securities and Exchange Commission in its report on Investment Trusts and Investment Companies transmitted to Congress under date of March 13, 1940, sets out that there were then only three companies of this type. They were Investors' Syndicate, Fidelity Investment Association, and United Securities Company of Missouri. The report states that the first two occupy a "predominate position" in the field. (Report, pp. 2-3.)

The report further states that the United Securities Company of Missouri is the only other sizable corporation which, so far as available information indicates, offers face amount installment certificates or contracts to the public. It was pointed out in the report that the installment or

thrift certificates sold by this company did not fall in the same category as the face-amount certificates sold by the other two companies, which were the special subjects of the study embodied in this Report. It is stated in the Report that state officials apparently have not required deposits to secure certificate liability of United Securities Company of Missouri, because the face-amount certificates of that company were collaterally secured under trust agreements, and were, in effect, collateral trust certificates. (Report, pp. 121-124.) Manifestly, United Securities Company of Missouri, for the purpose of the question under consideration, is unlike Fidelity.

This leaves as the only other company which has sold face-amount certificates secured by deposits with state officials before the Investment Company Act went into effect, the Investors' Syndicate. The District Judge, in his opinion, refers to this company, saying: "This regulatory law [The Investment Company Act of 1940] has not had the effect of banishing all such companies from the region of commercial operation. The testimony discloses that at least one other such company is still in operation, presumably with some measure of success." (Printed transcript, p. 29.)

Investors' Syndicate, as the evidence in the case discloses, is the only investment company which has become a registered face-amount certificate company under the Investment Company Act of 1940. It has been operating in some manner as a registered face-amount certificate company since January 1, 1941, the effective date of that Act. It did not, so far as the proof discloses, undertake to transform itself into an insurance company prior to the effective date of the Act. Nor did it cease to issue face-amount cer-

tificates after the effective date of the Act. The status and characteristics of Investors' Syndicate is therefore now, at least in the respects noted, wholly dissimilar to the status and characteristics of Fidelity Assurance Association when the petition was filed.

Now, let us notice carefully the precise question which Securities and Exchange Commission says is of so great importance in the administration of Federal statutes that it ought to be settled by this Court. The question is not, as they say, merely as to the "eligibility for and amenability to corporation reorganization under Chapter X of face-amount certificates and other investment companies which procure incidental insurance power, making insubstantial use of them." (Memorandum of Securities and Exchange Commission, p. 11.) The question is inadequately stated in these terms. More exactly stated, the question is: whether or not a company which having, (a) over a period of years issued and sold face amount certificates which were secured by deposits of securities in trust, in accordance with the laws of the several states in which certificates were sold requiring such deposits to be maintained as a condition to the right to sell such certificates therein; (b) prior to the effective date of the Investment Company Act, became insolvent and found itself unable to comply with the requirements for a face-amount certificate company under that Act; (c) amended its charter so as to become an insurance company, and from and after that date did everything possible to become an insurance company, as distinguished from a face-amount certificate company, for the avowed purpose of avoiding compliance with that Act; (d) six months later, after having obligated itself as an insurance company on 9,802 insurance contracts and; (e) in this period received payments on outstanding face-amount con-

tracts previously issued which it could not lawfully have done as a face-amount certificate company because it did not register under the Investment Company Act but had a lawful right to do as an insurance company, was an insurance company within the meaning of Sec. 4(a) of the Bankruptcy Act when it filed the petition for reorganization under Chapter X.

This question has never arisen before. Obviously it will never arise again. The decision of this question settles nothing as regards Investors' Syndicate, the only other company which was even remotely comparable to Fidelity when the latter filed its petition for reorganization. For many reasons, unnecessary to be noted here, the decision of this question involves no principles which can have even indirect application to any problem of reorganization or liquidation of other corporations, sometimes loosely called investment companies. An inevitable consequence of an attempt by this Court to declare principles of law to govern in other cases which may arise in the future involving problems of reorganization or liquidation of other types of investment companies generally, would be that in each such case various questions of conflict between the decision of this Court in this case and the decision of Courts of Appeal would be presented. By taking jurisdiction to review the decision of the Fourth Circuit Court of Appeals in this case, this Court would be committing itself in advance to a review of most, if not all, of the cases which Securities and Exchange Commission envisage. This Court, in undertaking to review in this case, would not be *settling* any important question of Federal law; rather, it would be *disturbing* a just decision on an unimportant point of Federal law which can never again recur.

QUESTION II—GOOD FAITH.

Will Interest of Contract Holders Be Best Subserved by Proceedings for Reorganization, Under Chapter X?

The reasoning of the memorandum of Securities and Exchange Commission on this point, it seems to us, is predicated upon an incorrect assumption. The memorandum states that Fidelity kept books showing separately the status of the several series of face-amount certificates which it issued, and that particular securities acquired were allocated to the various funds. It further states that the state depositaries did not segregate the deposit of securities according to series, "even where they had notice of the particular series of contracts to which the deposited securities belonged." (Memorandum, pp. 4-5.) It is significant that identification of "they" is lacking. The only citation supporting this statement is to the opinion of the District Judge. These statements, it seems to us, are susceptible of an altogether erroneous implication—one that is not even warranted by the opinion of the District Judge.

The actual finding of the District Judge was:

> "In each of the contracts sold by the Debtor there was a provision, which is set out in the respective contracts as Section 1 thereof, whereby, with slight variation in language as to each particular class or series of contracts, the Debtor agreed to create and maintain a reserve fund for such particular class or series from payments made on contracts of that particular class or series, which reserve fund was to be used for the discharge of its liabilities on that particular class or series of contracts. On its books Debtor kept these various series funds separate and distinct, but prior to December 31, 1938, it deposited cash received from payments on all different series of contracts except

Series 'B' and Series 'D', in one bank account. Payments on contracts in Series 'B' and Series 'D' were deposited in separate bank accounts from their inception. At times when the reserve fund in one series was impaired by reason of withdrawals and maturities, so called 'interfund' loans were made, of which records were kept and on which interest was charged to the borrowing fund and paid to the lending fund. In making the deposits with the various state depositaries, *Debtor** did not at all times designate deposited securities as being owned by particular funds, and made no attempt to apportion its deposits of securities from a particular fund to the amount of cash liabilities against that fund in the state where the securities were deposited."

(Printed Record, p. 9.)

In view of the manifest earnestness with which Securities and Exchange Commission insists that there are difficult problems of distribution in this case which can best be settled in a single administration, we feel that the facts with reference to the creation of the state deposits should be brought squarely to the attention of the Court, and in somewhat more detail than in the opinion of the District Judge. Fortunately, the printed transcript, despite its incompleteness, embodies other portions of the typewritten record which will enable us to point out certain very important facts.

In the first place, no blame can be placed on the state authorities for the failure to segregate the deposited securities according to the various series funds. The state de-

* All italics herein are our own.

posit laws did not require such a segregation. The lack of such a requirement was not regarded as a justification for non-compliance with the state laws; for one of the allegations in the bill of complaint which Securities and Exchange Commission filed against Fidelity on December 14, 1938, was that the Association had failed properly to comply with these deposit requirements. The decree of the Federal court in the case, entered on December 22, 1938, enjoined the Association, among other things, "from purchasing and depositing with West Virginia or any other state insufficient securities or securities which do not meet deposit requirements, or failing to segregate and maintain at all times sufficient statutory deposit against appropriate liabilities." (Report of Investment Trusts and Investment Companies, p. 131.)

Although an unequivocal admission that the purpose or reason for the various changes in the certificates sold was the existence of deficits in reserve funds of the anterior series, could not be obtained from any of the officers of the company who testified, this inference is clearly warranted. No good reason was given by any of the officers who testified for the minor variations in the different types or series of contracts as they were made from time to time.

Provisions in each of the different series of contracts, with slight and immaterial difference in verbiage, obligated the company to create and maintain a special fund for the discharge of its liability under the particular series of contract. The reserve fund was to be set aside from payments received on account of the particular series. By the *express* provisions of each of the series of contracts, this reserve fund was to be invested in approved securities, and *deposited in trust as required by the laws of the State of*

West Virginia. There would be no difficulty in performing the obligations both to create and maintain the separate reserve fund from the payments from the particular series of contracts, and to maintain the required deposits in trust with the state officials, as long as the company had sufficient securities—or, in other words, was solvent. Difficulty in fulfilling both the requirements arose as soon as the company became insolvent.

For many years prior to the investigation made by Securities and Exchange Commission, however, Fidelity had failed to segregate and apply separately cash payments received from contract holders having the different series of contracts. It set up on its books an account which it called a General Fund. Apparently, this was a sort of conduit through which it, as frequently as the need arose, shuttled securities acquired from one series to cover deficits in the other series.

Fidelity's financial difficulties first commenced in 1929 and 1930. At that time the securities account amounted to over \$30,000,000.00, and there was about \$5,000,000.00 or \$6,000,000.00 depreciation. (Testimony of D. A. Burt, Printed Record, p. 270.)

The affidavit of Ben E. Jackson, an accountant-investigator for Securities and Exchange Commission, filed in the action brought by Securities and Exchange Commission against Fidelity Investment Company in the District Court of the United States for the Eastern District of Michigan in December, 1938, states:

> "The books and records of defendant reflect that from November 9, 1920, defendant has issued and sold to the general public about 200,000 contract certificates

for a total face amount of approximately $600,000,-000.00 as follows (to June 30, 1938):

Number of Contracts	*Series Contract*	*Total Face Value*	*Period of Sales*
38,504	Special Income	$113,330,000	November 1920-April 1925
21,843	Special Annuity	268,218,000	April 1925-February 1932
24,759	Income Reserve Series A	60,465,000	March 1932-June 1934
47,811	Income Reserve Series B.	102,126,250	June 1934-June 1938
10,457	Income Reserve Series D	20,690,400	July 1935-June 1938

As at June 30, 1938, 112,542 of these certificates were outstanding with a total face value of $276,223,450.

"Each series of contracts sold calls for the creation and maintenance of Reserves and Special Funds for the benefit of a particular class of contract holders. Special Funds include an Active Fund for each series, and a Maturity and Retirement Reserve Fund for Special Annuity, Income Reserve, Series A; Income Reserve, Series B, and Income Reserve, Series D, contracts. The Special Income contracts call for the creation and maintenance of a Special Income Paid Up Fund. For each Fund the contracts call for the purchase and deposit in trust with the Treasurer of West Virginia underlying portfolio securities as delimited by the West Virginia code or statute which regulates the conduct of the business of defendant.

"The Books of defendant do not reflect the creation and maintenance of Maturity and Retirement Reserve Funds for Special Annuity, Income Reserve Series A, Income Reserve Series B, or Income Reserve Series D Contracts, or a Special Income Paid-Up Fund until September 30, 1937. *Prior thereto, these Reserves and*

their assets were commingled with assets in defendant's General Fund, but with certain securities earmarked as belonging to Income Reserve Series B and Income Reserve Series D Maturity and Retirement Reserve Funds."

(Report on Investment Trusts and Investment Companies, pp. 236-237.)

Mr. Jackson's affidavit also sets out that the total of the deficits in the various contract funds on June 30, 1938, was \$3,497,052.12, and further summarizes Fidelity's juggling of the different series funds as follows:

"The defendant does not require physical segregation as to special Contract Funds of portfolio securities deposited by it with the Treasurer of West Virginia. This enables defendant to make substitutions and to effect interfund sales or transfers of securities, without notification to or the approval of the West Virginia authorities. Defendant has at various times failed to purchase and deposit in trust sufficient bonds and other securities as required and delimited by the laws of West Virginia and the terms of the various contract securities issued by defendant. Defendant has purchased and deposited with the Treasurer of West Virginia bonds and other securities in default or which did not and do not meet the requirements of the West Virginia statute. Defendant has failed to maintain at all times a sufficient deposit with the Treasurer of West Virginia and with other state officers and agencies as required by the laws of said states and by the terms of the contract securities issued by said defendant.

Defendant has deposited, in states requiring deposit, securities belonging to Special Contract Funds in excess of the liability of said Funds to contract holders residing in said states; using the excess to cover in part or wholly the liabilities of other Contract Funds; although representing to prospective purchasers: 'Securities Deposited with State Departments In Accordance With Legal Requirements In Each State in Which We Operate.'"

IX

"*For many years defendant has failed to segregate and apply separately cash payments received from specific classes of contract holders.* Continuing this practice, defendant now does commingle in one common bank account all monies paid in by persons holding Special Income, Special Annuity, and Income Reserve Series A Contracts, with the monies of defendant's General Fund. Defendant permits overdrafts between the various Contract Funds and between the General Fund and the various Contract Funds. Before 1933, no interest allowances were made to the lending Funds. These overdrafts are in violation of contract and statutory requirements as to investment and deposit. Due to these overdrafts, at times the General Fund was indebted to various Contract Funds in amounts in excess of $2,000,000, while at the same time said General Fund was operating a speculative Margin Trading Account in securities with New York City Brokers. From defendant's books and records and from defendant's daily report of bank balances, submitted daily to sixteen of its principal officers and directors, it appears that cash has been and is now being disbursed for the defendant's General Fund and

for various Contract Funds without regard to whether each of said Funds has a cash balance to its credit.

"Interfund overdrafts reached a peak total of approximately $5,000,000 as of September 30, 1936. At this time defendant's General Fund was indebted to various Contract Funds in the amount of approximately $2,000,000, and the Special Income Active Fund was indebted to other Contract Funds in the amount of approximately $3,000,000. These overdrafts were covered, so far as the bank was concerned, by defendant's drawing against cash balances to the credit of the Special Annuity Active Fund and the Income Reserve Series A Active Fund. As at December 31, 1937, interfund overdrafts between all funds Contract and General totaled $2,351,513.99, and as at June 30, 1938, $2,071,751.14.

"Various officers and directors stated in their sworn testimony that the above overdrafts resulted because certain Contract Funds had insufficient cash on hand to meet contract maturity, cash surrender, and loan demands. According to the testimony, overdrafts were essential because the 'borrowing' Contract Funds could not liquidate sufficient, underlying portfolio securities to meet cash demands, without suffering such heavy losses as to impair the solvency of the Contract Funds and the capital of defendant.

"As of December 31, 1937, the Special Income Active Fund was short $756,744.87 in its cash account and the Special Annuity Maturity and Retirement Reserve Fund was short $1,585,734.83. The underlying portfolio securities of these funds are carried by defendant at a 'book' value very substantially in excess of the then market value. If underlying portfolio securities were sold from these funds to cover cash overdrafts,

defendant would have to contribute cash equal to the loss, or difference between book and market value. Defendant's capital surplus and earned surplus at this time on its books amounted to $488,204.61. As of December 31, 1937, the difference between book and market value of the underlying portfolio securities of the Special Income Active Fund and the Special Annuity Maturity and Retirement Reserve Fund aggregated respectively $758,756.66 and $717,424.77. The only source from which defendant could make up realized losses in the various Contract Funds is from Defendant's General Fund. However, for the past several years and to date, defendant has pledged practically all of the marketable securities of its General Fund with the various states to cover deposits deficiencies in the various Contract Funds. If the General Fund should withdraw such deposited securities from the various states for the purpose of sale, other equivalent securities necessarily would have to be deposited. As of December 31, 1937, practically no such additional securities acceptable for deposit were available from any source.

"As of June 30, 1938, and as of October 31, 1938, the position of defendant and the various Contract Funds in these respects remained practically unchanged. As of November 23, 1938, defendant's 'independent auditors,' Wilson and Meredith (C.P.A.'s, Ohio), in commenting in their audit report for the month of October, 1938, pointed out the existence of the above-mentioned facts and questioned the practice of defendant's commingling the cash of various Contract Funds; of defendant's permitting the practice of interfund and General Fund Overdrafts; and of defendant's commingling of securities for the purpose of

deposit with various States. It was suggested that defendant take steps to correct the conditions resulting from said practices.

"The above situation explains why defendant has failed to maintain at all times the required reserves against existing contract liabilities, on a market basis, and why defendant has failed adequately to restore by contribution from the General Fund deficiencies existing at various times in specific Contract Funds."

(Report on Investment Trusts and Investment Companies, pp. 240-242.)

Mr. Hubert F. Young, who had charge of purchasing securities for Fidelity, and distributing the securities for deposit with the various states, called as a witness by the Debtor, testified in part as follows:

"Q. Generally how did you distribute these securities which were transmitted by you for deposit to the various states under their respective state laws? A. We always asked the states to approve the deposit before making the shipment.

Q. Was there any reference to the allocation of these deposits to any specific contract fund? A. No, not until recent dates.

Q. All right. And now, from 1932 up until say—when? 1939? A. '38 or '39.

Q. '38 or '39. You transmitted the securities for deposit in the various states, as required by them under their state statutes, without reference to segregation? A. That is correct.

Q. (Continuing) Of these securities to specific contract funds. Is that right? A. That is correct.

Q. But since 1938 you have made an effort to accomplish that, have you? A. Yes, we have."

(Printed Transcript, p. 215)

"(The Court) Mr. Young, explain why it was that you found it impossible to make deposits to cover the annuity contracts? A. Because we had them in other states who would not let us withdraw them, for instance, in West Virginia. We had to keep certain securities down here, and the Auditor of West Virginia or the particular officer in any state would hardly let you withdraw from that state to put them in another state, and we were short that much. The annuity account, of course, is one of the insolvent accounts, and *there was simply not enough securities to go around.*"

(Printed Transcript, p. 217)

Mr. J. H. Schellhase, an actuary and accountant for the company, testified as follows:

"Q. And it was not until the liability on that series of contracts in that particular state was substantially below the deposited amount that a request would be made by the company for the withdrawal of deposited securities? A. Well, I don't know—the only time that I recall—and I am not certain about it—is that the only time we requested the states to take down some of those securities was in 1939. *Most of the time I would say those securities were held out there for the increasing number of payments probably of some other contract fund, so that the deposit was maintained at all times either by that particular contract fund or by another fund's securities.*

(The Court) Let me ask you this. There were a number of funds shown on your own book, but your deposit in the state was just one deposit, wasn't it, and not separated into funds? A. I think that is—I don't know for sure about that, but I think it was just one deposit in a state.

Q. Then, even if one fund did accumulate a surplus in a state, *if some other fund was short, you couldn't get back any money from the fund that had a surplus could you?* A. No, unless we would put up securities of the same value in the fund that was short."

(Printed Transcript, p. 213; italics ours)

Mr. Frank J. McNulty, Secretary of the Company, testified in part as follows:

"Cross Examination.

By Mr. Farmer:

"Q. You mean by showing segregation by series that in some of the reports in showing the liabilities in the states you list special income so much, and special annuity so much, Series A, Series B and so forth, so much, and then show the total, but you don't mean that you broke down and said these assets over he. were for special income and these for Special Annuity and these for Series A—you didn't do that in the Tennessee Reports, did you? A. We were talking about the audit reports.

Q. I thought you were talking about the reports to the state? A. No, this is the audit report.

Q. Oh! you are talking about the audit report? Is that it? A. Yes.

Q. And not the certificates that you sent to these state officials? A. Well the certificates were also broken down by funds.

Q. That is what I said, in the liabilities, but not a corresponding breakdown by deposit of securities? A. Well, in some states it was filed that way.

Q. Yes, but you don't mean that was the general practice, and you have outlined the special instances where that was done? A. Yes.

(Mr. Farmer) That is all."

(Printed Transcript, pp. 222-3)

After the Detroit injunction, Fidelity had annual audit reports prepared by the auditing firm of Haskins & Sells. The descriptive booklets embodying this report which were filed with the state officials, contain separate financial statements of the different series of funds. It was plainly stated, however, that the securities shown on the books of the company as being held for the different funds, because of state deposit laws, were not necessarily held for the funds. Three of these descriptive booklets were filed in the record as Exhibits 85, 86 and 87. We are not able to quote the exact language of the note with reference to the state deposit laws because we do not have a copy of the printed transcript, nor a copy of the descriptive booklets. Note 4 on page 11 of Exhibit 85, however, sets forth the statement plainly showing that such segregation as was made, according to the books of the company, were subject to the state deposit laws.

Mr. Arthur Koontz, general counsel for Fidelity Association, testified that his firm was consulted from time to time about the notes to be put in the auditors' report, explanations to be made, etc., so that there would be no violation of the injunction issued by the Federal Court in Detroit. Mr. Koontz states that these notes were submitted to representatives of the Securities and Exchange Commission before the booklets were published, and that he and Mr. Clark, the manager of Haskins & Sells, made a special trip to Washington to discuss this matter with the Securities and Exchange Commission. (Typewritten Transcript, pp. 3582-3588.)

We do not mean to suggest that Securities and Exchange Commission is in any way censurable for the failure of Fidelity to avoid violation of the Detroit injunction; for, as Mr. C. E. Smith, who was assistant secretary and a director of the company, admitted, although every effort was made to comply with the order, it was "very likely" that the company was unable to do so because of its condition of insolvency. (Typewritten Record, p. 1322.)

It seems to us therefore, that the foregoing clearly shows that no neglect of duty or wrong-doing is imputable to the state officials having custody of the state deposits. In the first place, there was no duty resting upon them to segregate deposited securities by contract series. In the second place, even if there had been some duty, they could not have been expected to perform the impossible. Plainly, prior to the investigation of the company by Securities and Exchange Commission, little or no effort was made by the company to make such segregation by funds. After this investigation by Securities and Ex-

change Commission, separation was impossible by reason of the company's insolvency. Neither situation in any way derogates against the state deposits. *It was because of just such a possibility which might entail serious loss to contract holders that the state deposit laws were enacted.*

We pointed out in our brief in opposition to the petition, that the validity of the state deposits had not yet been challenged in this litigation. Even now the memorandum of the Securities and Exchange Commission contains no suggestion of any grounds on which the validity of the state deposit laws can be brought into question.

Therefore, we are at liberty to proceed with the examination of Securities and Exchange Commission's argument on its Point II by assuming that *legally* no distribution of the securities held in state deposits (amounting, as Securities and Exchange Commission concedes, to 95% of the total "assets") could be made without giving full recognition to the deposit laws of the several states. But Securities and Exchange Commission insinuates that it must first be determined whether the state deposits are solely for the benefit of local residents and not for the benefit of all contract holders. What does this mean? Does it mean that by some inexplicable process all of the state deposits are to be brought into hodge-podge? No reason is given why this could or should be done. Inasmuch as it seems to us that it is beyond the pale of possibility that the rights of contract holders may be so far ignored as to bring all the deposited securities into one general pot with the general assets of Debtor, so as to make all contract holders merely general creditors, we will confine our further discussion to a demonstration

of the fallacy underlying the next insinuation made by Securities and Exchange Commission with respect to the state deposits.

Securities and Exchange Commission in its memorandum further pose this question:

> "(d) it must be determined whether states which accepted deposits from Fidelity to secure contracts in a particular Fidelity series, with knowledge that the securities deposited constituted a fund belonging by contract to another series may keep such assets.
>
> "It is obvious that security holders from states without deposits or states with inadequate deposits must litigate these questions in each of the fifteen states having deposits, unless there is to be a central administration in a court of bankruptcy."

Surely Securities and Exchange Commission does not mean that such questions are inevitable. No such issue is in the case at the present time. There is no reason why such a question should ever be made, regardless of whether the state deposits are distributed by the states in accordance with the decree of the Court of Appeals, or whether there is to be some kind of administration of these deposits in a court of bankruptcy. Such litigation would only be fruitless and expensive to contract holders, because there is no possibility of any re-shuffling or redistribution of the state deposits at this time on the basis of such bookkeeping entries as were made by the company with respect to the different series of funds.

We showed in our brief in reply to the petition that *valid trusts* came into existence when the securities were

deposited according to the state deposit laws. Now, we wish to show the obverse of this—that no valid trust came into existence at any time until the deposits of securities were made by the company with said depositaries. This means, of course, change of possession, actual or constructive.

Until the Company transferred securities to the State depositaries, they were still (notwithstanding bookkeeping entries) under the unfettered dominion and control of the Company. They should be "switched" about from one ledger account to another. They could be "loaned," or "advanced." The record shows many such transactions in very large sums. There was no attempt even to make separate bookkeeping entries until the latter years of the Company's existence.

The different contracts themselves when analyzed furnish conclusive evidence that no trust could come into existence until securities were deposited with State officials. In the first place, the contract holder was to make his payments *to the Company.* Undoubtedly the payments when received by the Company became its *absolute* property. The company agreed unconditionally—so far as reserve funds were concerned—to make the payments to the contract holder when due according to the terms of the contract. It did not agree to pay only *out* of the separate reserve fund. The contract holder's right to receive the payments from the Company was not limited to any special or segregated fund.

At no time throughout the whole period was there a trust fund or *res* until the Company parted with posses-

sion of securities by delivering them to the various depositaries.

McKey v. *Paradise*, 299 U. S. 119, 81 L. Ed. 75;
American Service Company v. *Henderson* (4 C. C. A) 120 F. (2d), 525;
Continental Casualty Company v. *Powell* (4 C. C. A) 83 F. (2d), 652.

The legal impediments to the attempt to redistribute the securities held in state deposits, according to the various contract series, are as great as those barring an attempt to completely abrogate the state deposit by throwing all of the securities into hodge-podge. Moreover, there is no evidence whatsoever in the record tending to show that there is any possibility of making such a redistribution of the deposited securities on any fair or reasonable basis. So not only is there the *legal impossibility* of doing what the Securities and Exchange Commission timorously imply may be done, but there is such a *mathematical impracticability* as to be tantamount to an *impossibility*.

There is no evidence in the record tending to show that it is possible to make such a re-allocation of the securities as would be required. The evidence was taken on the issue of whether there is a reasonable chance of *reorganization*. Debtor sought to show that the company could be *rehabilitated*. The insistence that a plan of "slow and orderly liquidation" would meet the requirements of Section 146 (3) of the Bankruptcy Act was injected in the case as an afterthought.

None of the auditors or accountants who investigated the affairs of Fidelity for Securities and Exchange Commission were called as witnesses. The only disinterested

witness possessing the necessary qualifications to testify on the subject was Mr. Latta. Judge Moore asked him the question whether or not it would be *possible* to prepare a plan of reorganization for Fidelity from an *actuarial* standpoint. The answer of the witness was in the affirmative. Judge Moore, however, refused to permit any of the counsel for parties opposing reorganization to ask the witness whether or not, in his opinion, it was *probable* as distinguished from *possible*, that a plan of reorganization from an actuarial viewpoint could be worked out. (Typewritten transcript p. 3511.) He further declined to permit the witness to answer the question whether it was *unreasonable* to expect that a plan of reorganization for Fidelity could be effected. (Printed Transcript, pp. 179-180; typewritten record pp. 3353-3374.)

Mr. Latta, however, later was permitted to make some explanation as to what he meant in his response to the Court's question, and we quote from his testimony as follows:

> "MR. PALMER: Q. Mr. Latta, will you please explain your answer to the Court's question when he asked you if Fidelity could be reorganized actuarilly—I don't know the exact question, but you answered the Court's question 'Yes.' Would you explain your answer, please? A. Actuarilly whether it could be reorganized strictly from a mathematical viewpoint, as I interpreted his question to be, would be as to whether there could be computed, as far as figures are concerned, in order to place this Company in a solvent condition, ready for operation on a sound financial basis as of that time. That is my interpretation of what he meant."

* * * * *

"MR. PALMER: Q. In other words, whether or not you could possibly construct an actuarial plan for Fidelity and your answer to that bears no relation to what your answer would be as to whether Fidelity could be successfully rehabilitated, is that correct? A. They are entirely separate questions.

"Q. And bear no relation to each other? A. No. (Printed Transcript, p. 184.)

Mr. Latta further testified that the various loans and interfund transactions rendered it impossible to determine what amount each series fund had. (Printed Transcript, pp. 238-239; Typewritten record p. 3568.)

A fair epitomization of his testimony as to the inextricable confusion of the different series funds is:

". . . as far mathematically speaking, you cannot determine the exact solvency of any fund due to the problems that are presented, you might say." (Typewritten record, p. 3274.)

Granting that some readjustment between series funds is physically and mathematically possible, how could it be done on any basis that is not wholly arbitrary? When the Detroit injunction was made the Company had around $28,000,000 in State deposits. (Report on Investment Trusts and Investment Companies, p. 130.) After this injunction in 1939 the surrenders were heavy (printed transcript, p. 212). During the two years that the company operated after the Securities and Exchange Commission enjoined it from failing to segregate funds, it lost around $8,000,000 from withdrawals by contract holders. It was insolvent during this time. It did not and could not segregate funds. It followed the old

policy of robbing Peter to pay Paul. So, even if a trust relationship with respect to each series contract could by enforced—and we have already demonstrated the unsoundness of any such theory—some Special Annuity contract holders for example, have been paid with series B monies. This money cannot be recovered. What about the millions which were turned back to contract holders before any bookkeeping separation by series was attempted? (Report on Investment Trusts and Investment Companies, pp. 108-109.) Too much water has already run over the dam to try at this late date to attempt any readjustment of this labyrinthine maze of figures on any now-as-for-then basis.

Had the issue of the possibility of a re-allocation of the securities between the different contract series been raised in the case before the hearings were concluded, it would have been easy to demonstrate in more detail why such a thing is unthinkable. If we suppose that it would be possible for auditors, accountants and actuaries after innumerable court hearings and appeals, to *construct* records for the many thousands of contract involving millions of dollars that were issued before the company commenced keeping records for each series separately, the first question that arises is, Will any of us now in the litigation live to see the task finished? The company operated two years after the Securities and Exchange Commission enjoined it from such activities and didn't do it. Mr. Latta worked on these problems seven months and couldn't do it. We feel safe in saying that the chances of such a thing ever being done can only be represented by a fraction not unlike Prof. Montague's, which had a numerator of 1 and a denominator which stretched from here to one of the fixed stars.

Litigation over these questions will not arise if the states are permitted to proceed with the liquidation and distribution of the deposits. It cannot be shown that any class of contract holders would benefit from the raising of such questions. The average claim of each contract holder is $250. Who would be willing to trade his chance for a certain 80% payment immediately for *any kind* of payment which might be promised to him five or ten years from now? Contract holders would choose the bird in hand even if somebody else should offer to pay the lawyers' fees for all the litigation—and wisely and prudently so.

The argument of Securities and Exchange Commission on this point, it seems to us, begs the question. The proposition is that the federal court has jurisdiction not because the best interests of contract holders will be subserved by liquidation through a simple administration in a court of bankruptcy. It is that the federal court has jurisdiction because *questions* can be raised in a court of bankruptcy that cannot or will not be raised in the states where the deposits are held. There is no showing that there will be any benefit to contract holders from a determination of these questions. There is no showing that the questions must *inevitably* arise before there can be a distribution of the state deposits according to the state laws. No attempt is made to show that even if a bankruptcy court has jurisdiction and the questions are raised, the best interest of contract holders will thereby be subserved.

The questions do not exist in the case now. Jurisdiction depends on the questions being raised. They can be raised if there is jurisdiction. Therefore there is jurisdiction. Around and around we go in the circle.

Since the questions are not now in issue, they do not say that the Court can settle them now. All they ask is for permission to go back to the Dictrict Court. There they can be raised and bruited about for a season. Eventually, of course, they will land in this court. Years and years from now they will be settled. We submit that the final judgment then would be that the state deposits must be upheld as they were when the petition was filed.

The further point is made that the Bankruptcy Court must determine whether the local deposit is for the benefit of the contract holders who resided in the state when the contracts were sold; who resided there when the deposits were made, or who now reside in the state. The evidence utterly fails to show that these questions possess any substantial importance.

It is said in the petition that in five states the local statutes exclude non-resident contract holders from participating in the local deposit. The memorandum fails to show which five states are referred to. We cannot speak as to the laws of the other states, because we have not studied all of them. The Tennessee statute, however, clearly secures only those contracts sold in the State of Tennessee. We are constrained to believe that there is little or no ambiguity in the other statutes. Granting that there may be a few cases where questions will arise as to whether or not a particular contract holder is entitled to share in a particular state deposit, there is no reason why such possibility should be determinative of this case.

Some twenty million dollars is now held in state deposits which contract holders need and want. The distribution of this entire amount should not be held up in order that

questions which may possibly come up as to a few thousand dollars can be determined in a bankruptcy court rather than in the state where the questions arise. If a claim is disputed, it will be a very simple matter to pay dividends on the other claims and set aside a fund to cover the disputed claim. In this case we think our guess is as good as the other fellow's. We imagine that no controversy of this nature will arise as to 99-44/100% of the amount of deposits.

Again it is said that the bankruptcy court ought to have jurisdiction so that it can be determined whether the measure of claims is the cash value of the contract, the reserve value, the amount necessary to mature the contract, the amount paid in, or some other amount. At the same time, it is conceded that there is little probability of a surplus in any state except Wisconsin. To state an example: In Tennessee, the amount of deposit, according to the testimony at the hearing, is less than the total of the claims. No contract holder in Michigan, West Virginia or any other state will have any claim against the Tennessee deposit. What difference will it make to contract holders in any of the other states whether the basis of distribution in Tennessee is the cash value of the contracts, the reserve value, or any other amount or value? These questions affect only the contract holders in Tennessee among whom the deposit is to be distributed. Since there is a certain amount to be distributed among Tennessee contract holders, the amount of a possible claim which Tennessee contract holders would have against the West Virginia deposit is limited to the difference between the amount of the deposit and the aggregate of the claims. Say that difference is $25,000.00. It makes no difference, so far as the rights of contract holders in West Virginia and the other states

against the West Virginia deposit are concerned, which group of Tennessee contract holders have the claim."

The best interests of the contract holders will be subserved by a simplification of the issue, the cutting of red tape, and the elimination of technicalities. The contract holders would rather get 80% of their claims now than 85 or 90% ten years from now. Having purchased their contracts in reliance upon Fidelity's representations that the contracts were secured by deposits in accordance with the state laws, all the contract holders will feel that justice has been done when their rights are determined by their own state courts. None of them want anything that belongs to contract holders in any other state. It is impossible to see how any contract holder or any class of contract holders could benefit from the paltry but protracted litigation which Central ~~Trust~~ Company and Securities and Exchange Commission hold in prospect in the Bankruptcy Court.

CONCLUSION

When this litigation was commenced, the proponents of reorganization had it in mind to disregard the state deposits. Hence, the turn-over order of June 9, directing that all state deposits be delivered to the Central Trust Company. It has gradually dawned on them that such a thing could be done. All questions now have been winnowed from the case except the trivalities which have been glossed since the Court of Appeals dismissed the petition.

The distribution of the securities belonging to the contract holders of Fidelity will not be cumbersome and difficult unless we purposely make it so. About $10,000,000.00 of the securities, or one half of the amount involved, is held in the West Virginia deposit. The other one half is held in thirteen other states. By reference to the schedule of deposits shown on page 225 of the printed transcript, it can readily be seen that four states—Alabama, Iowa, Missouri and Wisconsin—have apparently adequate deposits to cover liabilities in those states. These deposits aggregate about $3,500,000.00. Six states—Delaware, Illinois, Kansas, Kentucky, Maryland and Tennessee—are apparently 75% or better secured. The aggregate of the deposits in those states is approximately $4,800,000.00.

Therefore, in the ten states mentioned about $8,300,000.00 can be distributed among contract holders forthwith if the proceedings in bankruptcy are dismissed. There is no reason why the West Virginia Courts cannot determine the rights of the claimants to the West Virginia deposit as expeditiously as the Bankruptcy court can. We see no reason why the larger part of the West Virginia deposit cannot be paid out forthwith among the contract holders on the basis of admitted rights and claims, reserving

enough to make final settlement after the determination of the rights of all claimants.

It only makes the problem sound difficult and involved to mention the fact the contract holders reside in all of the forty-eight states. The table showing the geographical distribution of certificates in force (Report on Investment Trusts and Investment Companies, p. 166) shows that in most of the states the claims are inconsequential. It is reasonable to expect that few contract holders in the better secured states would go to the trouble of filing claims against the West Virginia deposit. This would result in the realization by contract holders in the states having the lesser security of a larger percentage of their claims.

There is no reason why any contract holder need expect to get less than 75% of his claim if distribution is made immediately on the basis of the state deposits before the funds have been diminished by losses, fees and expenses. It cannot be demonstrated that there is any possibility of any group of contract holders faring better by distribution in Bankruptcy.

At this particular time many contract holders have an urgent need for their money. It will entail serious hardship and loss to the contract holders to postpone distribution of millions of dollars while the lawyers wrangle over a congeries of points concocted out of the law of permutations and combinations. Since the decision of the Court of Appeals, the states have been going ahead with procedure for distribution, preparing to send out claims, etc.

The hopes of the contract holders of getting their funds released have been aroused. Justice will be done only by

making payment to them on the same basis on which the contracts were sold and which they have counted on for all these years—the safeguards of the state deposits — and without further delay.

Respectfully submitted,

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